Market Commentary

April 2016

EXECUTIVE SUMMARY

- Q1 2016 has seen volatility at extreme levels. Banks, Commodities and China all featured
- The longer term outlook for Banks has deteriorated globally, though near term rally would not surprise
- A strong rebound in oil, iron ore and gold suggests the commodity cycle is bottoming out
- China pessimism has not been supported by data. Rebalancing being supported by monetary and fiscal policy
- Australian equities offer solid growth in 2017 and valuations are fair. Underweight Banks, O/W Industrials, looking to add BHP

An Extraordinary Start to 2016

In what is seasonally one of the more positive and less volatile quarters, the opening stanza of 2016 proved to be the complete opposite. The Dow Jones Industrial average experienced its largest inter-quarter turnaround since 1933, rising almost 15% from its February low to a March high. Gold had its strongest quarter since 1986, rising almost 20% from its low to high. The Australian 10 year bond had its strongest rally since 2011. Iron Ore rose 24% and oil rallied nearly 60% from its February low. European bank share prices declined 25% and Japanese banks fell 35%.

So what lies behind this volatility? Given their prominence in our share market, three factors of particular relevance are Banks and Resources (accounting for more than 40% of ASX market capitalization) and China, as our major trading partner.

Banks

The weakness in banks is complex, and varies from region to region. First, low and declining interest rates are unhelpful for banks and their earnings. Negative interest rates in the Eurozone and Japan appear particularly unhelpful to bank earnings.

Second, since the GFC a positive yield curve - where short rates are much lower than long term rates - has been really helpful in rebuilding the capital base and earnings for banks. In recent times and particularly in 2016, yield curves in most major economies flattened significantly as long term interest rates have fallen sharply. This has been detrimental to bank earnings prospects.

Third, higher capital requirements and increased regulatory oversight are leading to lower returns on bank's equity. We have also seen diminished risk appetite by lenders. A reluctance to borrow amid higher funding costs continues as baby boomers repay debt as retirement looms, regardless of the low underlying base rates. Credit growth is likely to remain low.

Finally, there is the threat of declines in western world property markets at a time when bad debts are at historic lows. This has become an elevated risk for bank earnings and potentially capital position.

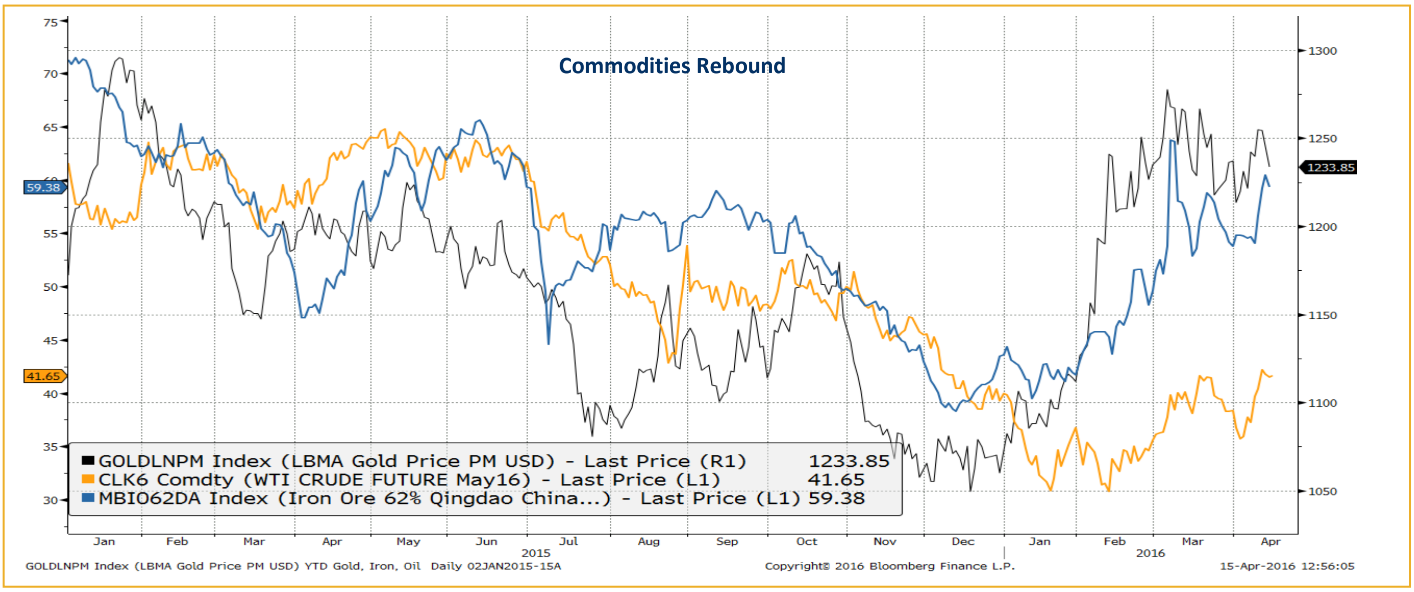
Importantly, it is hard to see any of these materially improving in the short to medium term, and indeed the risks appear to be biased to the downside. We will discuss bank share prices later in our commentary.

Have Commodities Bottomed?

There are still plenty of reasons why investors would stay cautious on commodities. However the sharp price movements experienced during the first quarter do suggest that perhaps the worst may be over. There is a case for commodities to have retested long term cyclical lows, although these cycles can be very long term.

The strength of the recovery in oil, gold and iron ore should not be ignored. Oil appears to be responding to the prospect of lower production in the US. China's new commitment to infrastructure spending as well substituting higher cost, local iron ore with cheaper imports has seen prices improve. Gold's strength may be related to concerns over central banks diminished effectiveness. There is also potential inflation risks' emerging from tightening labour markets in the western world.

From an investment perspective, we are reconsidering BHP for its diversified base metals, other commodities and energy exposure.



China Not As Bad as Expected

At the start of the year, a lot of the commentary on China was dire. Forecasts of an “economic hard-landing”, a sharp fall in the Renminbi and a banking sector crisis filled the headlines.

A quarter on, many of these predictions have proved wide of the mark. Growth has been relatively stable above 6.5%. The currency has been one of the more stable and the bank index in China has significantly outperformed those in other western markets.

In the meantime, commentary around the emerging Chinese middle class and its implications for both China and rest of the world has become much more visible. Australia is no exception. Almost daily we see commentary across a multitude of sectors of the opportunities emerging for Australian businesses. Sectors mentioned in our January Market Commentary included tourism, property, food, healthcare. To these would also add logistics, financial services and education.

Stability in Volatile Times

In volatile times, it is worth restating our investment philosophy for holding stocks. Also our thinking for preserving your capital.

- In a lower growth world, the core business must have positive growth characteristics. Growth should be based on demographic or secular trends, rather than cyclical
- Investing in “thematic” growth sectors and stocks with global exposure
- Businesses must be sustainable
- Earnings and cash flows need to be relatively predictable.
- Balance sheet strength is a necessity
- Management must have a proven track record
- Portfolio risk is managed via sector, stock selection and asset class diversification

Prospects for Equity Markets

Although volatility has produced mixed results over the last quarter, the majority of portfolios continue to run ahead of longer term, market based benchmarks.

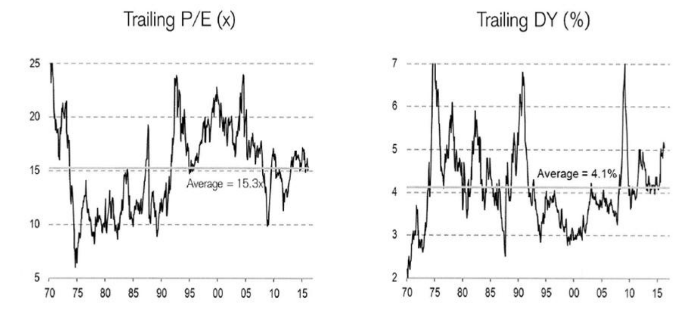
In a low inflation world, including Australia, generating consistent revenue growth is proving challenging. Sector and stock selection are paramount. Sectors that fit comfortably into the framework include Healthcare, Infrastructure, Transport/Logistics, new Media/Technology, Telecoms, select REITS and Industrials. We have recently added Adelaide Brighton as an exposure to the strengthening infrastructure sector. As highlighted above, BHP is under consideration.

The major conundrum we face is Financials. Representing close to a third of the market index, our position has been to hold an underweight position to the sector in growth portfolios. We do recognize that their dividend yields are attractive at 8-11% including franking. Given the share price falls over recent months, we believe a lot of potential bad news is now reflected in valuations. A further downward leg in prices, we believe, would require a significant fall in Australian property prices. At this stage, outside of inner city apartments and mining exposed regionals, this is not our base case.

Political factors seem destined to play an important role in markets over the balance of 2016. It appears Australia will now have a “double dissolution” in July, the potential UK European exit “Brexit” vote in June and the US Presidential elections in November. Opportunities will abound as markets ebb and flow. Historically the first term of a new government/administration can be problematic. However, we believe that ‘economics lead politics’ in the direction of markets.

In summary, our intention is to remain defensive, staying with investments with sustainable growth and income prospects. We continue to be positive on a number of small / mid cap opportunities for a part of portfolios.

Market Valuation: Cheap on dividends, fair on earnings



Source: Company Data, Credit Suisse

We look forward to catching up with you soon to discuss your portfolio and any change of circumstances or issues that we might be able to help you with.

Ian Wenham
Director

Richard Nicholas
Director

Andrew Martin
Director

Contact details

Level 11, 56 Pitt Street, Sydney NSW 2000
GPO BOX 2058 Sydney NSW 2001
Phone: (+61 2) 8274 5800
Fax: (+61 2) 8274 5899
Email: info@peakinvest.com.au
www.peakinvest.com.au